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SUBJECT: CZECH REPUBLIC: SKILL GAPS IN LABOR MARKET  
THREATEN LONG-TERM COMPETITIVENESS AND FDI

REF: A. PRAGUE 607

1B. PRAGUE 1239

1C. PRAGUE 1173

1. Summary: The Czech Republic has been the darling of foreign investors in Central Europe, and as a result FDI is the number one engine of GDP growth. Foreign investors have taken advantage of the low-cost, highly skilled workforce and duty-free access to the EU to build mostly assembly plants, warehouses, and factories. With Romania and Bulgaria set to join the EU January 1, 2007, there are concerns regarding the sustainability of high-levels of FDI in the medium to long-term. The government investment promotion agency CzechInvest in 2003 started to refocus investment incentives to lure software and technology service companies, high value-added investments, and businesses that are less likely to move east in search of lower labor costs. However, labor shortages in qualified engineers and managers have prevented large-scale investment in these sectors thus far. This skills gap threatens to persist and reflects serious structural issues in education (post will report on Czech education reform via septel). Reforms needed to fulfill the goals of the Lisbon Agenda and to transform the country into a mature, services-driven market economy have only been further postponed by the current political stalemate (reftel A). End Summary.

12. The Czech Republic's economy has been booming in recent years, thanks in large part to foreign direct investment (FDI) (reftel B). Beginning in 2003 with the run-up to EU accession, Czech GDP growth has been steadily climbing. According to the Czech National Bank, the economy grew by 3.2% in 2003, 4.4% in 2004, and a whopping 6.0% in 2005. Analysts are estimating GDP growth of 6.0% for 2006. FDI shot up to a record USD 11 billion in 2005, from USD 4.9 billion in 2004 and USD 2.1 billion in 2003, making it the largest recipient of FDI in Central Europe and 20th largest in the world. Former Deputy Vice Prime Minister for Economic Affairs Radek Spicar notes that foreign companies were initially attracted to the Czech Republic because of its macro and micro-economic stability, along with its relatively cheap, well-educated labor force and favorable location. This, combined with a strong infrastructure, has led to rapid development of assembly plants of various sorts, from cars to laptop computers to plasma TVs, largely for export to Western Europe.

Troubles Ahead: Will FDI Continue at Current Levels?

13. Despite being one of the fastest growing economies in

Europe, there are legitimate concerns about medium to long-term sustainability of FDI and, in turn, GDP growth in the Czech Republic. Director of Investment Rene Samek from the investment and business development agency CzechInvest is worried about future growth, and with good reason. A recently released (October 2006) Ernst & Young European Investment Monitor Report shows a downward trend in the overall number of investment projects in the Czech Republic and other Central European countries, down from 19.8% in H1 2005 to 12.8% in H1 2006. Manufacturing projects are moving east, and Sofia is now the fifth most popular destination for projects across Europe. In a country where, according to the Ministry of Industry and Trade Survey of the Czech Economy 2005, 73% of all exports were machinery and transportation goods, the loss of investment projects is a troubling sign that Czech competitive advantage in wages and location may be eroding. Czech wages are still much lower than in the west (3.42 Euros/hour in the CR versus 16.18 Euros/hour in Germany), but are growing quickly: the 12.6% growth in wages since 2005 is the fastest rate in the EU.

¶4. Since 2003, CzechInvest has refocused its investment incentives to try to attract software and service-sector investments, investments that have staying power. For investing as little as CZK 15 million (USD 750,000) and creating as few as 15 new jobs over a three-year period, companies can earn corporate tax relief for up to 10 years, financial support up to USD 8,900 per employee, and reimbursement up to 35% of employee training and retraining costs, according to CzechInvest. This policy has generated some success, winning business deals from the likes of Honeywell, IBM, and Accenture to build research and development and service support centers, but is exposing some weaknesses (i.e., low number of available skilled labor) of the Czech labor force to compete in an information economy.

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Samek said that if a company requested 500 R&D engineers, he would recommend India.

¶5. Samek says that the skills gap is forcing some companies to search for engineers from outside the country and work with universities directly. Companies such as Honeywell are actively recruiting engineers and other IT workers from Russia and Ukraine. This is supported by the Ministry of Labor and Social Affairs, which in 2004 launched a directed migration program that puts work visas and residence permits on a fast track for people with targeted skills. IBM has a program with the Czech Technical University in Prague to train faculty and students, offer internships linked to studies and IBM projects, and fund and provide technical expertise for thesis work. This gives IBM the advantage of recruiting and hiring engineers before they finish their studies.

¶6. The government has proposed new legislation that is currently in Parliament, which will change tax incentives for major investments in the manufacturing sector. Beginning in 2007, manufacturers would qualify for tax breaks for machinery and technical investments that require highly qualified technicians to operate rather than assemblers. If approved, the proposed law would amend the landmark investment incentive legislation first passed in 2000, which has helped bring the bulk of foreign investment to the Czech Republic.

#### Transforming the Workforce: Need for Education Reform

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¶7. There is broad consensus that Czech long-term competitiveness will hinge on human resources rather than on wage or location advantages. To ensure continued economic growth, the Czechs must be better skilled in the sciences and in foreign languages, but there are institutional problems in education that prevent this from happening. The Czech Republic's Lisbon Agenda National Reform Program points out

that secondary schools face a shortage of qualified teachers, computers, and counseling services, and universities still need to reform their curriculum to offer shorter, more practically-oriented degree programs. Despite a soaring economy, the amount of public funding devoted to education is relatively low. Education spending in the 2007 proposed budget amounts to 3.04%/GDP, down from 3.4%/GDP in 2006 and up from 2.46%/GDP in 2005. Czech educational expenditures are among the lowest in the EU, whose average is 4.9%/GDP.

**¶18.** The budgetary pinch has kept secondary teacher salaries low and is having a big effect on recruitment, retention and quality of teachers. According to a recent article in the daily newspaper Pravo, Czech monthly salaries for all secondary teachers are CZK 18,771 (USD 850), and for foreign language teachers, CZK 16,000 (USD 720). These pay scales represent an increase of 6.6% over 2005, but still fall short of the national average salary of CZK 20,096 (USD 915). Figures from the Czech Statistical Office support this. In a pay survey covering 17 different professional fields, educators came third from last, with only forestry workers (hunters) and hotel and restaurant workers earning less. Teachers are demanding a 25% pay increase, but the Education Ministry has refused to consider it because of the government's current budget problems (reftel C).

**¶19.** Lower salaries have created staffing gaps at schools, especially in foreign languages. According to an article in the business daily Hospodarske Noviny, there are five times more English philology students at the pedagogical faculty than there were 10 years ago. But only a few will choose teaching as a career when they can earn twice as much in the private sector with their language skills alone. Schools are lowering standards as a result of the shortage of teachers. According to one report, only 29% of foreign language teachers have a teaching credential.

**¶10.** Insufficient spending on education is delaying the country's transition to an &information economy.<sup>8</sup> In 2002, the Ministry of Education launched its Internet for Schools program that aimed to provide all state schools with computers and a connection to the Internet. This program helped reduce the gap from 1 computer per 50 pupils to 1 computer per 14 pupils. However, according to a survey on the use of Internet communication technology by households and individuals in 2006, half of the Czech population has never used a computer. Former Vice Prime Minister for Economic

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Affairs Jiri Havel explains that the digital divide is a socio-economic divide between wealthier families with computers and Internet at home, and those who must rely on the public schools for computer training.

**¶11.** Perhaps because of their lack of exposure to computers and technology, Czech students have relatively little interest in pursuing studies and jobs in the computer or engineering fields. Ministry of Education Department of European Integration Head Michal Kadera reports that the acceptance rate for Czech Technical University in Prague (CVUT) is 85%, whereas it is 43% for humanities-oriented Charles University. Overall, Kadera says that two-thirds of all Czech students are studying humanity-related subjects, such as languages, economics, and law, though the jobs are elsewhere. Today, Czech technical universities graduate 5,000 engineers a year, which is 55% of the EU-25 average. According to the Czech Labor Office, more than 9,000 technical and IT jobs are going unfilled.

**¶12.** The Czech Republic has one of the lowest percentages of university educated adults in the EU because of a high student drop-out rate. Only 11% of the population has a university degree, in comparison to 19% in the EU. Recent statistics from the Ministry of Education show a 50% jump in the student population from 2000 to 2005, but almost 30% will withdraw before graduation. Spicar notes that even though

many universities have introduced shorter three-year bachelor programs, most Czech university students prefer masters degrees. Kadera also says that among public universities master-degree programs dominate and lack any practical orientation. Kadera again believes that a revamped curriculum with shorter and more practically-oriented programs along with career counseling is the solution.

¶13. Comment: The Czechs lag significantly behind the EU in several important areas and need many structural reforms in education to catch up. The percentage of the population with university degrees is 60% of the EU average, and the percentage of graduates with technical or science degrees is 55% of the EU average. No matter who forms the next government, education reform needs to be addressed for the long-term sustainability of a small, FDI-dependent open economy like the Czech Republic. End Comment  
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